Investing in Unsettling Times – April 2022

Our recent Quarterly Commentaries have focused on the market impact of inflation, interest rates and the Covid pandemic. As the economic impact of Covid recedes, a terrible new event in the first quarter of 2022 has captured the world's attention – Russia's attempted invasion of Ukraine. With financial and military supply assistance from the Western world, Ukraine has at least temporarily thwarted Russian President Putin's plans to unseat its Western-leaning government; however, military analysts expect a fierce and renewed Russian military effort to seize at least some eastern regions of the country. Expectations now are for a protracted bloody conflict and for the West's ongoing relations with Russia to be affected for years to come.

In this article we'll assess the impact of these world events on investment markets and our investing strategy.

The Impact of Russia's Actions on the Global Economy

Although it represents only about 1% of global economic output, Russia has a significant impact on three key global commodities markets:

1. Oil - Russia produces about 10% of the global oil supply, 50% of which is exported. This translates into a potential supply shortfall outside of Russia of 4 to 5 million barrels per day. To counter this, countries around the world are working to make up any shortfall and reduce further reliance on Russian energy.
2. Natural gas – Russia is the largest exporter of natural gas in the world, with three-quarters of its exports going to Europe. This dependency is significant for electricity, particularly in the wake of the shutting down by some European countries of nuclear and coal-fired plants.
3. Potash – Russia produces about 40% of the world's total potash supply, which directly affects agriculture production.

In addition, Ukrainian production of a significant portion of the world's supply of neon gas, used in making computer semi-conductor chips, has halted because of the conflict with Russia.

It is important to note that Canada is a significant producer of oil, natural gas, potash and neon gas.

The international sanctions being applied against Russia will impact supply chains, creating dislocations and the shifting of supply and demand further away from equilibrium, adding to global inflationary pressures.

Russia's invasion of Ukraine may have indirect consequences for relations between major global powers. China's and India's passive reactions to date to the Russian invasion may contribute to an expansion of future military action beyond Ukraine and damage international relations and global economic growth.

Inflation and Interest Rates

In January, annual inflation rates among developed countries rose to about 7%, reaching the highest levels in the last 30 years. We've discussed in past newsletters the reasons for the increase in inflation, many of which resulted from the economic impact of the pandemic.

Here in North America, after nearly two years of keeping their overnight lending rates at historic lows, both the U.S. Federal Reserve ("the Fed") and the Bank of Canada ("BOC") increased interest rates during the first quarter of 2022, a first move to reset rates to within an "acceptable range" and to address inflationary pressures. Markets are anticipating up to six additional hikes in 2022 and possibly three more in 2023. These most recent moves by the Fed and the BOC, and the tone of their communications, indicates a clear shifting away from the pandemic-induced "stimulus at any cost" mindset to one of tempering the economy and reigning in inflation. The BOC may have a little more latitude than the Fed given the economic boost provided to the Canadian economy by rising commodity prices.

The Impact of Ukraine, Inflation and Interest Rates on Financial Markets

As the financial markets absorbed information on Ukraine, inflation, interest rates, forward growth rates, and the strength of the consumer, the first quarter of 2022 saw substantial changes to valuations in the equity and fixed-income markets.

Many growth stocks, where valuations are based more on future-based earnings flows than current inflows, experienced notable declines. Corporate earnings across the board are beginning to reflect slowing top-line growth (although this is not totally unexpected due to rapid drop and then rise in earnings in the first 12 months of the pandemic). Some industries and companies are less able than others to pass on rising labour and borrowing costs.

The economic environment has also impacted the normally "boring" bond market, which suffered losses in the first quarter due mainly to rising interest rates and a rare occurrence known as the "flattening yield curve." While long-term rates are increasing, they are doing so at a slower pace than short-term rates, resulting in a flatter curve when plotted on a graph. In the past, this inversion has been an often-reliable leading indicator of economic decline or recession.

Investing in this Unsettling Environment

History has shown us that economic shocks, for the most part, are unforeseen and their duration and impact difficult to project. As a result, we invest our clients' savings in a way that we believe will best respond to such unpredictable disruptions. Nevertheless, as events unfold, we adapt to new information with tactical adjustments to our investing strategies. Here are some of the guiding principles our portfolio management team is following:

- While rising interest rates have had an impact on the bond market, we maintain a relatively short bond ladder (1-to-5-year issues, held to maturity) for our clients, which ensures a locked-in yield despite some price volatility. We do not pay large premiums for bond purchases, which helps protect our clients from large swings in the price of their bonds as they come to maturity.
- We continually monitor the shape of the yield curve. Analyzing the spreads between various fixed-income instruments, equity markets and overall economic growth rates helps to guide us in our strategic allocation of our clients' investments.
- We carefully select the companies that our clients own. We look for companies and industries that have pricing power, that can pass increased costs through to their customers. These companies can sustain earnings and dividend growth and provide a partial hedge for our clients against inflation.
- We assess the changing profile and outlook of the overall economy. To paraphrase a Wayne Gretzky quote: "Focus not on where the puck is, but where it is going." The economy is evolving faster than ever before: new technologies, consumer preferences, a renewed awareness of our vulnerabilities, social responsibilities, and future global growth and prosperity means the "economic pie" will look different in the future than it does today.

Although we employ tactical shifts to navigate the changes, challenges and opportunities the world continually presents, we do not abandon the disciplines of diversification and fundamental asset valuation. A properly diversified strategy during such turbulent global events remains paramount.